

Moscow Financial Weekly

For the Week Ending February 22, 2002
Treasury Attache's office, US Embassy Moscow

Highlights This Week

- Standard and Poor's upgrades forecast from stable to positive.
- Big Five accounting firms meet with FCSM.
- Focus: **Managing Russia's Debt**

Key Economic Indicators

Indicators	Level	% chg 1 week	% chg since Jan. 1
Ruble/\$ (MICEX) UTS	R30.8409	0.07	2.33
Monetary Base*	R688 bln	1.39	-2.89***
CPI	NA	NA	3.1
International Reserves*	\$36.8 bln	0.55	0.82
RTS Index (end of week)	295.35	0.61	13.57
Refinancing rate	25	0	0

*For week prior

** % chg from the abnormally high seasonal level at the end of the year.

Economic Developments

The bond rating agency **Standard&Poor's** has upgraded the forecast on Russia from "stable" to "positive." According to agency representatives, the upgrade was based on the improved implementation of reforms, helping to diversify sources of economic growth away from exports. Another reason for the increased rating was probably the reduction of the 2003 external debt payments.

According to Goskomstat, the the final **trade surplus** was \$49.6 billion last year, \$11 billion less than last year. Last year exports were down by 2.4% while the imports were up by as much as 19%. In dollar terms exports were \$103 billion and imports - \$53.39 billion. This reflects real appreciation of the ruble and lower prices for natural resources.

Retail trade in January increased 10.1% year-on-year, supported by a large 8.5% year-on-year increase in real disposable income and an 18.7% year-on-year real wage increase. For the moment, it seems that consumer spending is continuing to drive economic growth with industrial output and investment still shrinking. Official unemployment remains at 9 percent, the same as last month. Though the data is positive, the dependency of growth on consumption (rather like the U.S. economy, in fact) is somewhat worrying especially if other components of GDP do not pick up. Without domestic investment and

production, consumption will tend to flow toward imports and real income growth is unlikely to be sustainable at its current pace. Last year's story was that growth in industrial production and investment finally flowed through to wages and disposable income. The risk is that this year will show that this effect works the other direction too.

The **"big five" auditors met with FCSM** on February 27 to discuss auditing practices in Russia in light of the Enron scandal. The meeting identified several areas to consider for reform, including level of fees, scope of services, election of auditors (and for what time period), and disclosure rules, some of which are protected under Russian law as state secrets. Areas were identified which need legislative action and others that could be put into place by the FCSM more quickly. In addition, auditors complained that accounting education in Russia is lacking, with no training in international accounting principles. Accountants produce company data that auditors frequently cannot use. At the meeting, Bill Browder of Hermitage Capital gave an extensive presentation concerning his crusade against Gazprom and its auditors, who he claims gave their seal of approval to asset stripping practices that destroyed shareholder value. While that situation is not analogous to what happened at Enron, Russian companies may be worried that the valuation gains made by certain Russian companies with improved governance practices will be wiped out by investor backlash from the Enron scandal.

At the **AmCham sponsored conference "Russia on the Upswing"** Finance Minister Kudrin emphasized the successes Russia has achieved to date in terms of fiscal surpluses, debt reduction, banking reform, and conversion to IAS standards. He also revealed the government's intent to begin medium-term (three year) budget planning to better manage resources. Nezavishimaya Gazeta was critical of the government's progress, saying that behind the facade of good statistics is a Russian economy with very serious problems that could undo the positive momentum at any moment. Izvestiya said that despite the title of the conference, most foreign investors are waiting until Russia shows some progress in implementing reforms before initiating new investments.

Banking sector

Russian banks had \$40.4 billion worth of loans outstanding to the real sector as of end-November 2001, the CBR reported last week. Of this total, 8 percent are retail loans and 92 percent represent corporate lending. Total loans equal roughly 13.7 percent of GDP, up from 10.8 percent in the same period in 2000. The length of repayment of corporate loans are shrinking, with the share of one year plus loans dropping to 23.3 percent, indicating that the loans are purely for working capital, rather than fixed investment. This coincides with Goskomstat figures that also show decreased fixed investment. On the other hand, the number of retail loans has been growing at an annual rate of around 100% since February 2001.

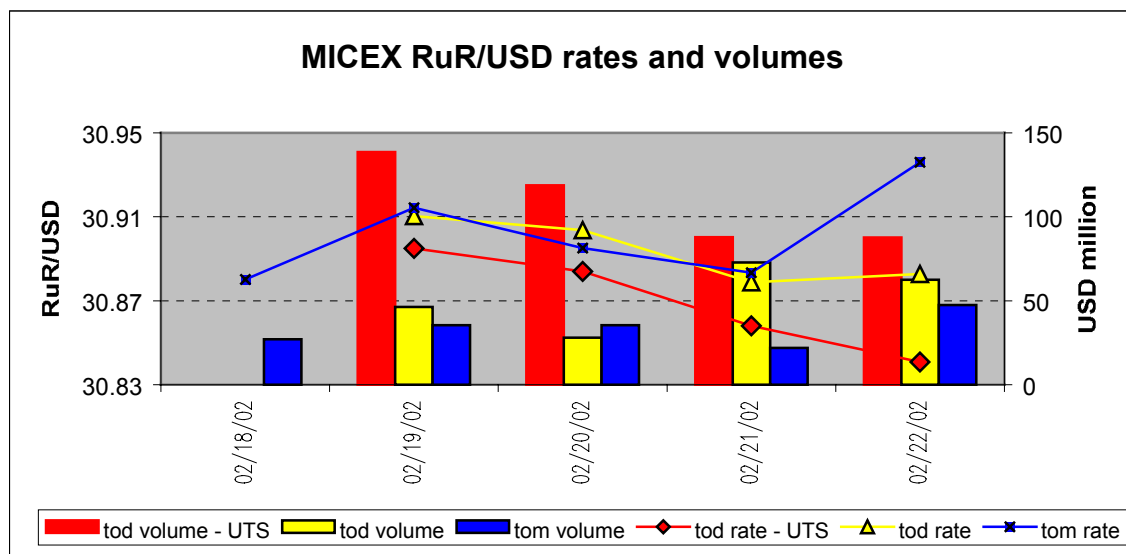
On February 19, the year's first foreign exchange auction for investors with **S-account rubles** took place. Demand was \$95.17 million, Interfax reported the Central Bank saying, with the bank offering \$50 million.

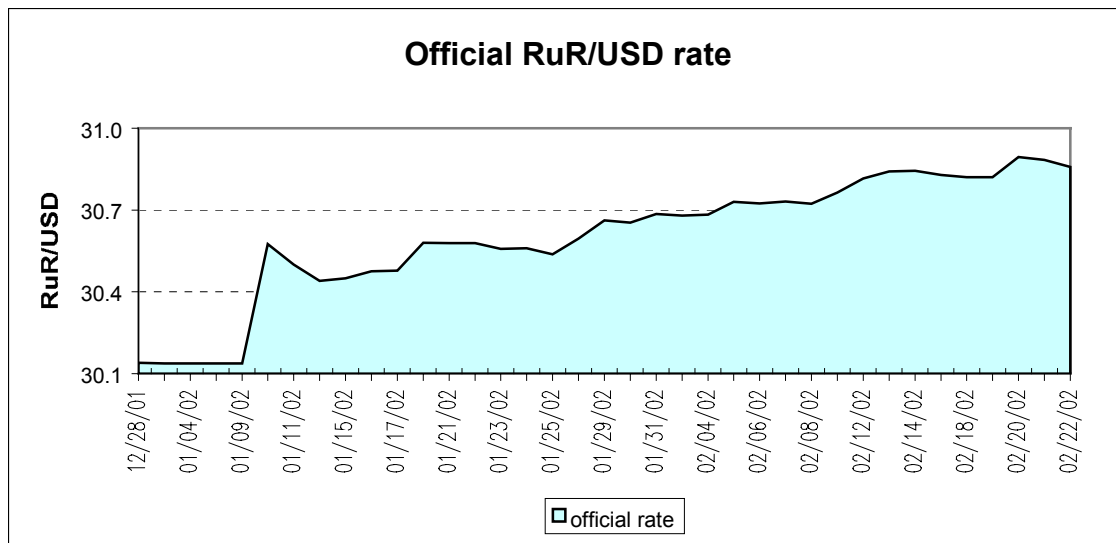
Financial markets

Forex Market

On Monday "tod" dollar was not traded at MICEX as US banks were closed on Presidents Day, but "tom" gained almost 4.5 kopeks. The next morning the dollar easily surpassed the psychologically important benchmark of R30.90/\$ in interbank trading. When the UTS opened on Tuesday, the CBR, after a week of absence, was again selling dollars at R30.895/\$. In that session it sold up to \$70 million thus bringing the session volume to almost \$139 million, the highest since the beginning of the month. After that the market was barely stable, the rate being driven only by the state of ruble liquidity, affected in turn by VAT payments due on the 20th. Only on Friday afternoon did the ruble started weakening again.

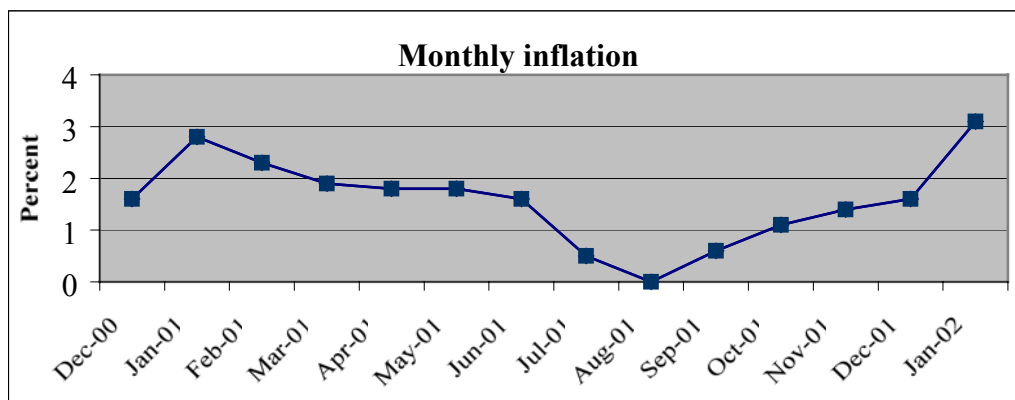
For the week, the ruble weakened 0.07%, closing in the UTS on Friday at 30.8409/\$. MICEX weekly trade volumes were \$432.93 million, \$209.72 million and \$167.40 million for the morning (UTS), afternoon "tod" and "tom" sessions, respectively.





Prices

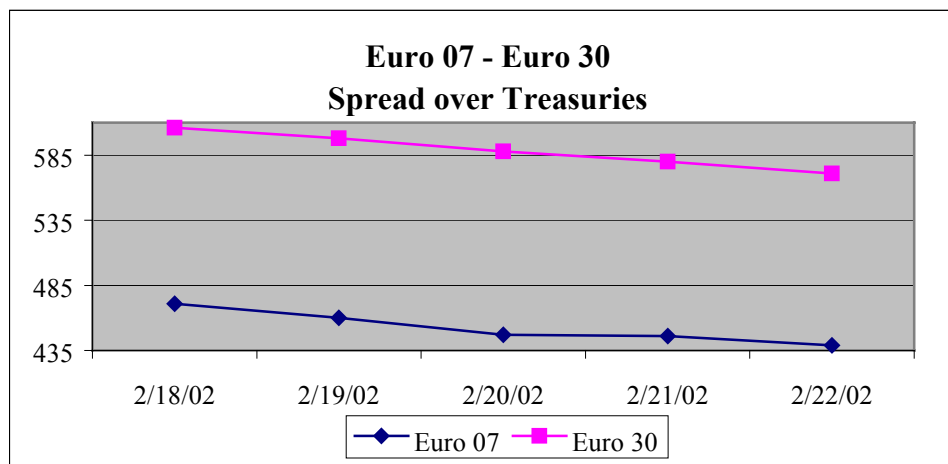
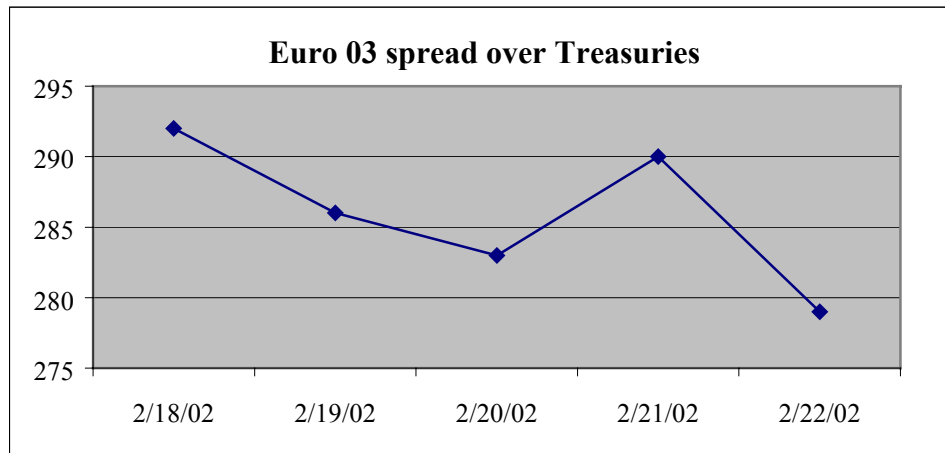
Goskomstat reported that inflation totaled 0.9% during the first 18 days of February. During the period of Feb.12-18, prices grew by 0.3%. Price growth has decelerated this month, which was expected. However, Russian producer price inflation was 0.3 percent month-on-month in January, slightly up from 0.2 percent in December, but down from 1.8 percent in the same month in 2001.



Eurobonds

Last week Russian Eurobonds experienced considerable growth and prices reached new record highs. Currently Russian Eurobonds are 5.5-5.7% p.a. higher than U.S. Treasuries while just a year ago, the premium was more than 11% p.a. The positive mood was the result of a stream of domestic good news from Russia, as opposed to recent weeks in which prices on Russian bonds were affected mostly by events in other emerging markets. First of all, world oil prices were on the rise. In addition, the Finance Ministry

confirmed that it was buying back foreign currency bonds, and Eurobonds maturing in 2003 on the secondary market. Although actual amounts were not revealed, this confirmation undoubtedly improved the outlook for Russia's repayment burden in 2003. Adding to the rally was Standard&Poor's announcement that it upgraded its forecast for Russia.

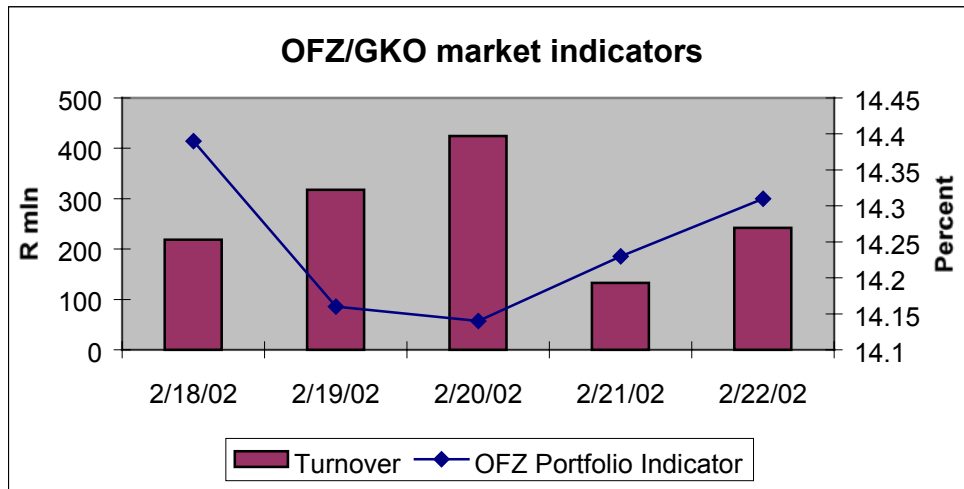


Interest/Bond Market

Bonds/Bills

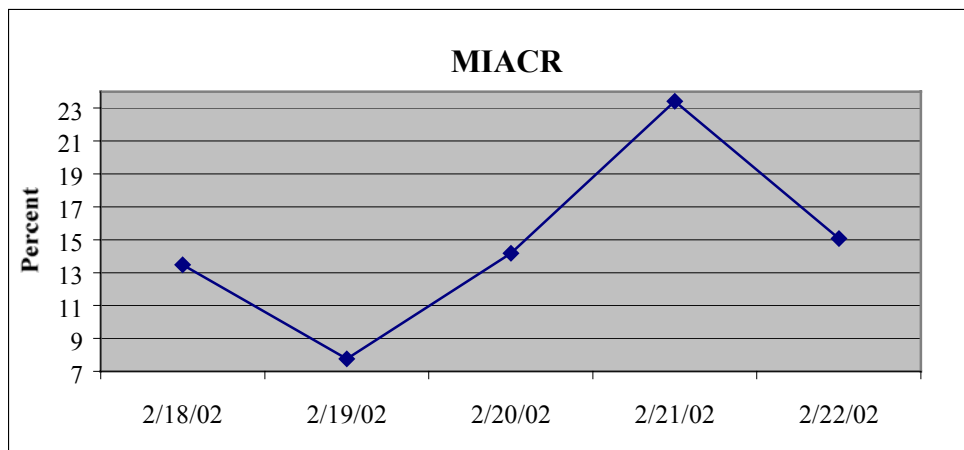
On Wednesday, market players were able to get quite a nice premium on the GKO auction, as the Finance Ministry softened their position on the auction and allowed bids for higher yields. Last week at a high-level Finance Ministry meeting, Minister Kudrin announced that despite the restraints of operating under a non-deficit budget, the government intends to use domestic borrowings in order to promote the interest of the investors and deepen the market. (see this week's focus) However, last week the market experienced some downward price corrections after the auction. Trade volumes were lower than average, increasing only on Tuesday and Wednesday on the upward beat,

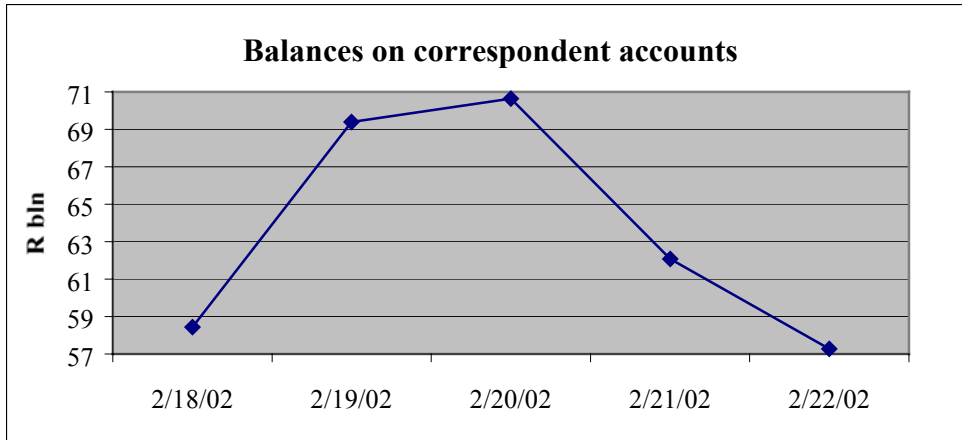
mostly due to the expectations of reinvestment of the proceeds from the GKO redemption. The lowered volumes during the rest of the sessions were explained by the continued ruble deficit last week (see below).



Overnight rates

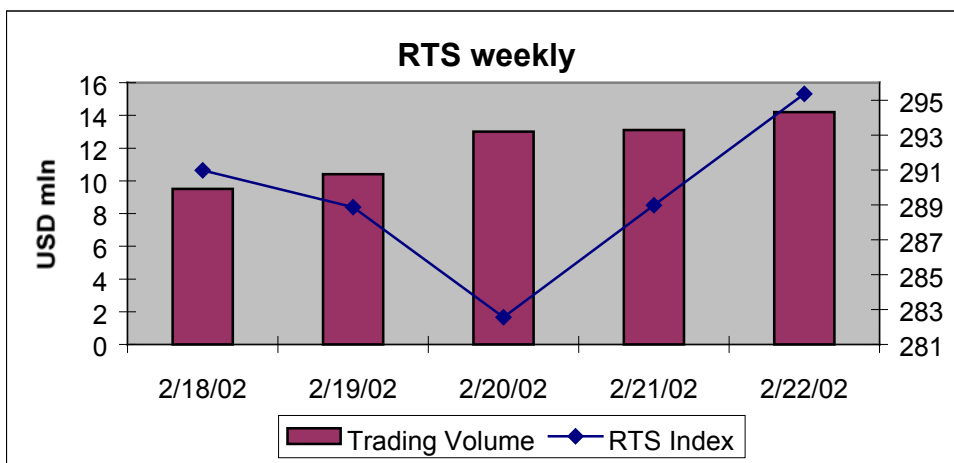
The ruble liquidity continued to be quite tight last week, with VAT payments due on February 20th. Thursday was the most "expensive" day of the ruble - overnight rates were up above 30% p.a. while the balances on banks' correspondent accounts stood at R62.1 billion. On Friday, overnight rates declined, but still remained on above-average levels.

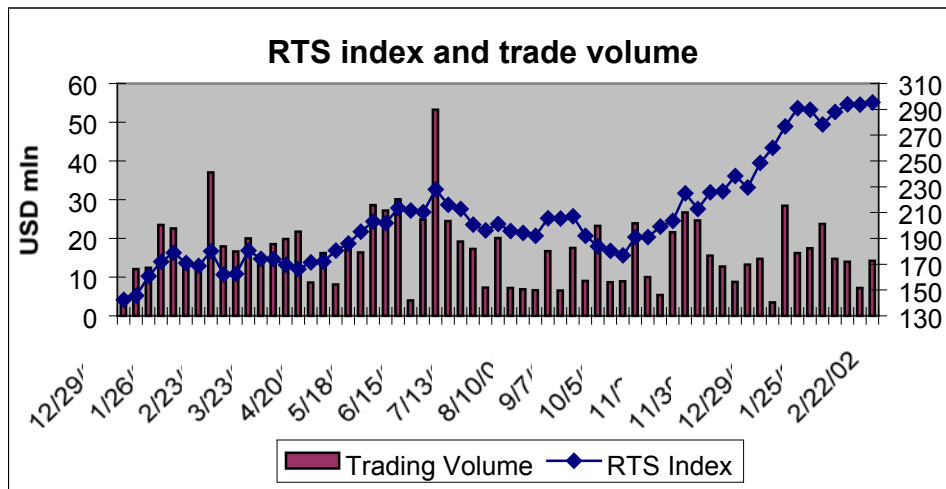
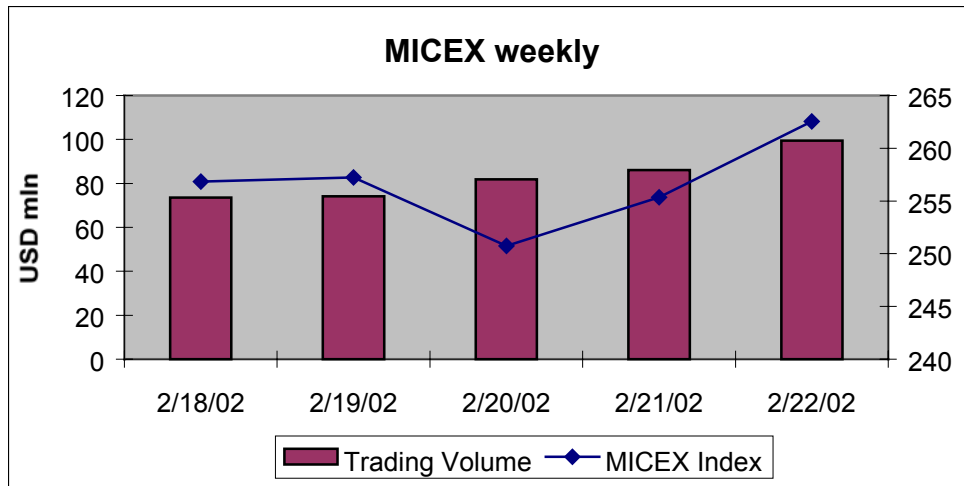




Stock Market

Last week, the stock market fluctuated in the corridor of 280-300. It opened lower on Monday with market activity constrained by the US President's Day holiday, and volumes registered only \$9.5 million. Downward price corrections continued throughout Wednesday, with the market focusing still on bad news from LUKoil's third quarter US GAAP results. However, the market rallied near the end of the week. On Thursday the market was up on good news from the US market, as well as positive news from YUKOS. It published quite positive GAAP financial statements for 3Q 2001, and its shares were up by 2.2%. On Friday, the market was up by 2.21% mostly due to the upgrade in the Russia's forecast by the most conservative rating agency, Standard&Poor's. Trading volumes increased during the last two trade sessions; however, they were still slightly lower than average. For the week, the RTS index was up by 0.61% in dollar terms.

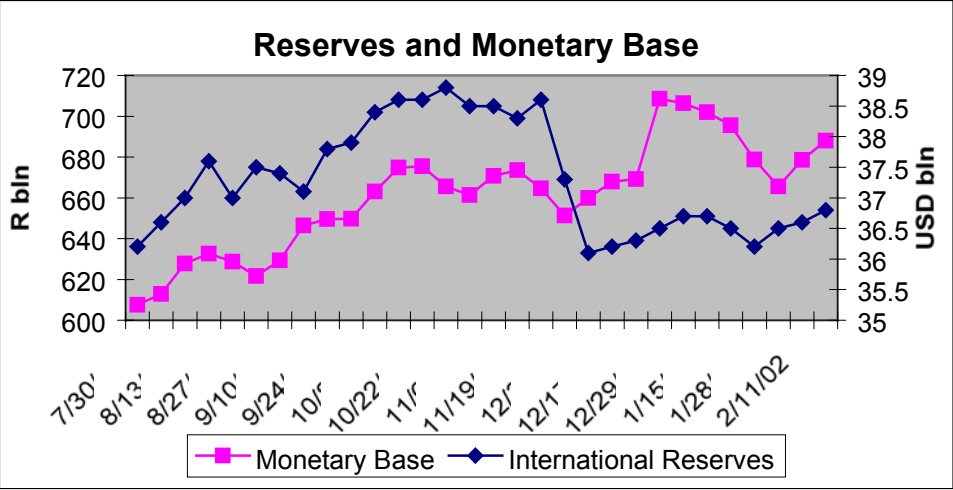




International Reserves and Monetary Base

International reserves reported last week were up by \$200 million to \$36.8 billion. This week however they declined by \$600 million due to roughly \$1 billion in external debt payments due the week of the 20th.

The monetary base was up again last week. It grew by R9.4 billion to R688 billion, which is still lower by 2.89% than the level of the beginning of the year.



Managing Russia's Debt

There has been a lot of self-congratulating by GOR financial officials in recent weeks over Russia's efforts to reduce external debt vulnerability and improve its status in the private debt markets. To a large extent this is justified. After a momentary reversion to prior form at the beginning of last year when it began to accrue arrears to the Paris Club, the GOR has shrewdly maneuvered its way out of a potential debt spike in 2003 through a combination of prepayments, swaps, and buybacks. Admittedly this was made easier by strong GDP growth, high oil prices, higher revenues, and a pliant Duma, but it still required a level of forward thinking and fiscal fortitude that had been rare prior to the Putin Administration. It is noteworthy that many of the prepayments and buybacks took place after oil prices had tumbled late last year. The results are impressive – foreign debt is now below 50% of GDP at \$138.1 billion; the domestic debt stock also dropped to 6% of GDP (\$17.9 billion) at the end of 2001 (which may be more of a mixed blessing as discussed later). Eurobond spreads on the secondary market dropped 725 basis points last year, putting Russia 250 points below Brazil on the EMBI and only 550 points above U.S. Treasuries. Russian bonds now represent 17.6% of the EMBI, behind only Brazil and Mexico. Interest rates on domestic debt remain at or below inflation at 15-17% at end 2001 - good for the budget, though less good for the markets.

All of this progress has been done without the benefit of a coherent structure for managing debt, something that the International Financial Institutions have been urging for many years. Now, however, the GOR appears ready to put in place a new agency to manage all of its sovereign debt – external and internal – with the apparent task of reducing further Russia's external debt burden while broadening internal debt markets. This week we review the GOR's recent debt management and prospects for the government's new debt strategy, including the controversy over the decision to rely more on domestic debt.

Recent Steps to Manage External Debt

Russia started 2001 facing a baseline of \$14B in annual external debt payments with a \$19 billion hump in 2003. The fact that the debt hump comes during a Duma election year and the year before Putin's reelection campaign was clearly a motivating factor in the GOR's aggressive approach. Putin did not want to face the choice of having to go the eurobond markets under potentially adverse external circumstances, or, notwithstanding G-7 promises of goodwill, negotiate a Paris Club deal where Russia could be required to make political concessions. The decision was thus made in early 2001 to deal with this problem sooner rather than later, and more broadly to reduce Russia's external debt dependence.

As it turns out Russia has been lucky – strong macro results and excess revenues have provided ample fiscal means with which to prepay \$1.3 billion in IMF debt owed by the GOR in 2002. Likewise strong reserves funded prepayment of \$1 billion owed by the CBR to the IMF in 2003. Besides lowering the future debt burden, these repayments, conveniently, were just enough to put Russia under its IMF borrowing quota, thereby

exempting it from mandatory post-program monitoring. Russia has also moved consistently along the path to restructuring FTO (non-state guaranteed former Soviet trade debt) of about \$6.6 billion and COMECON debt of \$800 million into Eurobonds in line with the terms it provided to London Club holders.

Meanwhile, less transparently, MinFin has been buying back large amounts (possibly up to \$2.0 billion) in MinFin 04 debt (which comes due in '03), and up to \$1 billion in Eurobond '03 debt. The budget code does not specifically authorize debt buybacks out of excess revenues. For this reason, and because it makes sense to keep these purchases a secret from the market, funds used to buy back debt have reportedly come from extra-budgetary sources such as profits on precious metal sales, or from state banks. Last week Russia, finally admitted that it was buying in the market, without providing any amounts.

The GOR has yet to succeed in convincing the Paris Club to participate in swaps, though it has been actively negotiating with Paris Club members on a number of fronts. It has managed to orchestrate swaps with sovereign creditors outside the Paris Club, including the Czech Republic and Bulgaria. This debt stems mainly from negative COMECON trade balances at the time of the Soviet Union's collapse. While the Czech deal was completed under rather shady circumstances, the GOR managed to settle the \$2.6 billion of debt for \$1.35 billion. In the recently announced Bulgarian deal, the GOR settled \$100 million debt for \$15 million paid in cash and the rest in military equipment and nuclear fuel supplies.

Finally, Russia has signaled it will take a new approach to debt to the World Bank, with a recent announcement that the government would reduce its overall annual borrowing to a maximum of \$400-\$500 million per year, eliminate budget support loans and focus on project lending. This may be more of a political statement than a real policy shift since many of these changes are already in place and monetary limits probably wouldn't be binding, but it certainly reflects a new hard-headed attitude.

Institutionalizing better debt management

On February 21 the GOR announced an outline for a new debt agency to finally bring all of the disparate arms of Russia's debt bureaucracy under one roof. This has been rumored for a number of months but now appears to be on track for final approval at the end of March. Still, with many difficult issues still outstanding, insiders say implementation could take at least another year. The plan has several components:

1) Creating a debt agency to manage all GOR debt, internal and external. Operationally this will be done by breaking off part of Vneshekonombank – which currently operates as the government's external debt agent and as a (albeit unlicensed) foreign trade bank – and merging it into the Finance Ministry's external debt and international financial market departments, which themselves will be combined. This entity will be called Vnesheconombank of the USSR and will be under full control of the Finance Ministry. While this process sounds relatively straight-forward, bureaucratic battles will be one of the toughest hurdles to implementing the new strategy, insiders tell us. Issues include

difficult questions of how to combine salary structures (VEB's are high, Minfin's are low) as well as thorny legal issues. In all of Russia's external debt agreements there is a prohibition on assigning the debt to another entity. Any reorganization into a new entity thus poses a problem in that it could give creditors the right to accelerate their claims. Russia will need to obtain a waiver of this provision from creditors, which, though presumably possible, will be time consuming. We are told this process will begin once other questions have been dealt with, possible by summer.

Substantively the goals of the new agency are fairly clear. It is intended to coordinate the management of foreign and domestic borrowings, including providing early warning of possible risks. The agency would seek to smooth peaks in debt repayment and lower debt servicing costs by coordinated borrowing in certain markets when conditions are most favorable. So far few details have emerged of exactly how the agency will be structured, but the GOR has asked the Finance Ministry to flesh this out by March 30.

2) Creating a new state bank out of the commercial part of VEB. For those who favor reducing the influence of state banks, this component is an unfortunate by-product of the re-organization. The current plan is to have the remains of VEB merge with Ros-Exim Bank, a relatively ineffectual state foreign trade bank with around \$30 million in capital, to create what would be called Vnesheconombank of the Russian Federation. Once formed, according to VEB, the new bank would issue up to \$2 billion in new shares, which would be purchased by the GOR with a combination of cash, securities and real estate. What first catches one's eye about this plan is that VEB is seeking exactly the same level of capital as Vneshtorgbank currently has. This is certainly not lost on the CBR, which, at least for the moment, owns nearly all of VTB. In fact, there appears to be significant horse trading going on between the GOR and CBR on the dual questions of a new VEB and VTB's proposed share issue to EBRD/transfer to the GOR. CBR clearly does not want to allow a direct competitor to VTB and may use its leverage to minimize VEB's eventual share issue or even undermine the merger with Ros-Eximbank. Speculation is that the merger itself is driven by the fact that VEB did not think it could secure a new CBR license on its own. There are also those in the GOR who oppose in principle the creation of another large state bank. Therefore, though VEB assures that its plans have the support of the President and the GOR, others doubt that its ambitions will ultimately be fulfilled. If they are, it will certainly be setback for Russia's banking reform process.

3) The final component of the new strategy was announced by Prime Minister Kasyanov and DPM Kudrin after the recent GOR consideration of the debt plan. They said an additional goal of the strategy would be to focus on domestic borrowing rather than external markets, in order to put a halt to the debt market's continued contraction and to make it a more efficient tool for financial intermediation. The announcement created surprising controversy. Presidential Advisor Andrey Illarionov sharply criticized Kasyanov, vaguely reminiscent of last year's public debate over debt payment to the Paris Club. Illarionov believes that Russia is not in a position yet where it needs to borrow extensively, due to budget surpluses, high foreign exchange reserves, and a positive trade balance. When the government needs to borrow again, Illarionov believes

that it should be done in the Eurobond market, where rates are lower than the domestic market.

Both points are fair as far as they go but miss the positive side of domestic debt for development of the monetary and financial system. An active and liquid domestic bond market is something that, in the medium term, Russia needs to help sterilize rubles and counteract inflationary pressures. In times of fluctuating oil prices and increased budgetary pressures due to structural reforms, Russia simply cannot count on strong fiscal surpluses to absorb inflationary pressures brought on by additional dollar inflows. In addition, to further develop capital markets, including mortgage and retail lending, Russia needs to develop a normal yield curve in rubles to act as a benchmark for borrowers and lenders. A look at Russia's yield curve, shows the points disbursed widely around a relatively short curve, making Russian bonds relatively useless as a benchmark. Finally, tight liquidity and the domination of Sberbank in the domestic bond market drives yields into negative real territory, meaning that banks and others in the financial system have no profitable way to manage liquidity.

Who is right in this debate will be determined by how the GOR's new focus on domestic debt is carried out. The recent domestic borrowing plan for 2002, announced by the government on January 25th, has some new components but, significantly, continues to target keeping interest rates low. The plan is to sell up to R165 billion worth of domestic bonds (though only R151B are assumed in the budget). With R118 billion in planned redemptions, this assumes a modest R30-45 billion (\$1-1.5 billion) in net new domestic debt. This will include R48 billion of GKO's, 97.5 billion of OFZs. For the first time MinFin will also offer up to R20B of GSOs, which will be non-traded domestic bonds for non-state pension and insurance funds. The GOR will increase the volume of each GKO issue to R4 billion and will carry out one auction per month. The higher volume may increase their liquidity slightly, but not much unless the target interest rate is higher. Certainly more predictability in issuance is welcome. What this plan does not seem to recognize is that a long-term commitment to expanding the domestic debt market must entail positive real interest rates and thus will cost some money to the budget in terms of higher interest costs. Clearly going too far brings the risks of crowding out private investment as happened prior to the 1998 crisis, but there should be room to strike a balance. With pension reform and banking reform now on the horizon, there will be increasing need for liquid domestic debt instruments to support stronger capital markets.

Conclusion

In late August 1998, few would have predicted that Russia would have come this far in reclaiming its reputation as a sovereign debtor. For those who did, however, the rewards have been tremendous. The fact that the GOR is now preparing to institutionalize its good behavior on debt for the long-term is a sign that, this time, the change is more than tactical. Barring unforeseen external shocks, prospects seem bright that the GOR's goal of further reducing external debt to 40% of GDP by 2005 will be met.

EXPLANATORY NOTES

1. EXCHANGE RATES: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell 50% of the repatriated currency. UTS fix (rounded) becomes the "official" ruble rate for the next day. "\$-tod" price is the price of the dollar with same day delivery. "\$-tom" is the price of the dollar with delivery on the next day. Minimum lot size for each of the dollar instruments is \$100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.

